TESTIMONY OF CHARLES P. CAREY

CHAIRMAN OF THE CHICAGO BOARD OF TRADE

BEFORE THE SUBCOMMITTEE ON

GENERAL FARM COMMODITIES AND RISK MANAGEMENT

OF THE HOUSE AGRICULTURE COMMITTEE

March 9, 2005

Mr. Chairman and Members of the Committee, my name is Charles Carey. I am Chairman of the Board of Trade of the City of Chicago. As the Committee begins considering the re-authorization of the Commodity Exchange Act, it is an honor for me to appear before you and to present the Board of Trade's views.

We commend this Committee and the Congress for passing the Commodity Futures Modernization Act (CFMA) and the Commodity Futures Trading Commission (CFTC) for its exemplary job in implementing the provisions of the CFMA. We in the futures industry are fortunate to have had Members of Congress and regulatory authorities who realize the importance of determining prices of goods and services through open, transparent competition between buyers and sellers reflecting the interplay of economic forces.

The Commodity Futures Modernization Act of 2000 provided much-needed regulatory relief to entities regulated by the Commodity Futures Trading Commission and granted the Commission flexibility to deal with new ideas and technological advances, while at the same time retaining concepts of customer protection that are essential to our industry. In addition, the CFMA brought legal certainty to many products either by removing them from Commission jurisdiction or by establishing standards and procedures by which products can be and remain exempt from further CFTC regulation. The CFMA also allowed for the trading of security

futures products for the first time. All in all, this legislation and its implementation by the Commission has been a clear success. While the industry has benefited greatly from the reforms of the CFMA, there continue to exist some areas of uncertainty, overlap and the risk of regulatory inconsistency that deserve discussion.

Regulatory Reform and Process

The CFMA established a system of core principles to guide regulated entities while maintaining CFTC oversight of compliance with those principles. The core principles system is a successful one that has provided U.S. futures market participants flexibility in managing business models and responding to competitive developments. Among other things, the CFTC has used the authority granted it under the CFMA to enhance the ability of self-regulating exchanges to govern themselves without undue interference by establishing procedures under which an exchange may put certain rules into effect without requiring prior approval by the Commission. This has relieved regulatory costs without losing the benefits of regulation. The CBOT supports self-certification, but would be more cautious in its application in two areas. First, new market entrants, for example, may have less experience in crafting rules that comply with all provisions of the Act, and we hope Commission staff will exercise care in reviewing such rules. The CBOT also believes that certain rules, such as those pertaining to non-competitive transactions like block trades, as well as those pertaining to incentive programs, should be evaluated very carefully since they have the potential to threaten market transparency and integrity. Especially in markets trading the same or similar contracts, such trade practice rules can have an impact well beyond just one exchange. In addition, some incentive programs that function as payment-for-order-flow have the potential to encourage wash trading or to cloud

brokers' fiduciary duties. Our entire industry has a vested interest in making sure rules of any exchange don't compromise the integrity of one or multiple market centers.

Legal Certainty and Fraud Jurisdiction

The CFMA eliminated the legal uncertainty that impacted over-the-counter derivatives transactions prior to its enactment. Today, there is a different kind of uncertainty affecting the industry - uncertainty related to the CFTC's jurisdiction over retail fraud. In a recent Federal court decision (CFTC v. Zelener), the Seventh Circuit ruled against the Commission and held that contracts that called for delivery of a commodity within two days were cash contracts not under the jurisdiction of the Commission, even though the contracts were typically "rolled over" and were leveraged through the use of margin. The contracts at issue in the case were nothing more than speculation in foreign exchange. The effect of the decision, however, cannot be limited to foreign exchange speculation. It provides a roadmap for unscrupulous persons to engage in over-the-counter contracts involving agricultural and other commodities, with no government supervision whatsoever, and entirely free of the anti-fraud jurisdiction of the CFTC.

The Chicago Board of Trade does not wish to see legitimate operators of electronic dealing systems forced to become Designated Contract Markets (DCMs) or be otherwise overly burdened with regulation. However, the potential future impact of this decision is a matter of concern across the futures industry.

Stock Futures Products

The CFMA ended the ban on single stock futures in the United States that had existed since 1982. Security futures, however, have yet to reach their potential. The CBOT, along with

the Chicago Mercantile Exchange and the Chicago Board Options Exchange, formed a joint venture – One Chicago – specifically to trade these products. However, exchanges, intermediaries and customers alike face difficulties arising out of the dual regulation of security futures by both the CFTC and the Securities and Exchange Commission. It is our hope that the collaborative process between the two agencies will become more productive and that the agencies will implement changes that may assist in making these products more viable. In particular, unfair and unnecessary margin inequities inhibit the growth of stock futures and their utility as hedging vehicles. Stock futures should be margined like other futures products if they are to have a chance to succeed.

There is also a technical issue arising from the definition of narrow-based security indexes. By not clearly distinguishing equity securities from other types of securities, this broad formulation may unintentionally capture indexes on fixed income securities, corporate bonds and other non-equity securities, suggesting some overlapping jurisdiction to the SEC on such indexes. This uncertainty inhibits contracts on indexes of such securities and deserves consideration at this time.

Issues Related to Cross-Border Business

One of the most clearly visible trends in the futures industry is that toward international expansion and cross-border business initiatives. One of the most notable developments on this front, of course, was Eurex's application in 2003 to establish a U.S. exchange. Short of establishing exchanges in other countries, exchanges from around the globe, including U.S. exchanges, regularly seek approval to offer their contracts to customers in other jurisdictions, and will continue to do so.

One of the novel cross-border initiatives currently under development is Eurex's plan for a "global clearing link." Essentially, the link is intended to allow customers to clear contracts traded on Eurex's German exchange at a U.S clearinghouse (Phase 1) and to clear contracts traded on Eurex's U.S. exchange at its German clearinghouse (Phase 2).

Phase 1 of the clearing link is currently operational. The Chicago Board of Trade believes that the structure of the Phase 1 link weakens protection of U.S. customer funds by allowing the co-mingling of funds held for customer business in U.S. futures products (segregated funds) with funds held for customer business on non-U.S. futures exchanges (secured amounts). The two separate regimes, segregated funds and secured amounts, were initially created by the CFTC due differences in international bankruptcy law that could cloud jurisdiction and dissemination of such funds in case of bankruptcy. The CBOT believes that the differences and uncertainty that caused the Commission to establish the two separate regimes still exists today, and we were disappointed to see that longstanding customer protection policy eroded in the context of the clearing link.

Phase 2 of the global clearing link would be designed to allow trades made on Eurex U.S. to be cleared at Eurex's German clearinghouse. Little has been made public at this point concerning how that might be structured. In late 2003, in a hearing before the House Agriculture Committee, the then-Chairman of the Commission stated that "[b]efore trades traded on a contract market in the U.S. could be cleared at a non-domestic [clearing house], we would require that the non-domestic clearing house come in and register as a designated clearing organization." The Chicago Board of Trade believes that to be good regulatory policy because it could lessen the potential for harm to U.S. customers.

It is our hope that when the Commission considers plans for this or other such cross-border arrangements, it will take the appropriate steps to ensure that all registration requirements are complied with and that the funds of U.S. customers continue to receive the same level of protection as they presently have on U.S. clearinghouses.

More broadly, as exchanges and firms across the globe look to do business in other jurisdictions, we urge the Congress and the Commission to keep in mind that the regulatory structures of other countries may not provide the same type or level of protections found in the United States. Other regulatory authorities may not have the same ready access to information that the Congress and the CFTC have found necessary to regulate markets and market participants efficiently.

The recent actions of a handful of traders in London selling and buying bonds through a European electronic trading system illustrate the potentially de-stabilizing effect that questionable market behavior can have across borders and between exchanges and marketplaces. Authorities and prosecutors in four countries are now investigating to determine whether there was price manipulation. This incident demonstrates the need for comparable regulation and information collection among international regulators.

In mid-February, the CFTC began discussions with the Committee of European Securities Regulators (CESR) to launch a "transatlantic cooperation initiative" the entities entered into last year. We hope that these discussions, as well as continuing bilateral talks, include not only efforts to lower unnecessary barriers to entry, but also issues of regulatory disparities and gaps that should be addressed as increased cross-border activity is contemplated.

The trend toward cross-border business presents special challenges for regulators at home and abroad. We are pleased that dialogue is taking place and urge extreme care in that exercise.

Decisions being made now with regard to policies and protocols for cross-border business are setting critically important and influential precedents that will impact the global derivatives industry for years to come. Just as it is incumbent on exchanges and other regulators of futures trading to be price-neutral in overseeing market participation, governments and authorities must take care that exchanges and electronic trading systems compete with each other under rules and procedures that do not confer competitive advantages that arise simply from different levels of regulation. The Congress explicitly recognized this by stating in Section 2 of the CFMA that one of the purposes of the CFMA was "to enhance the competitive position of United States financial institutions and financial markets."

The Chicago Board of Trade believes that international competition should be encouraged without yielding to regulatory imbalances which can endanger U.S. futures customers or establish competitive inequities. The Congress has built protections into the U.S. regulatory system which should not be disregarded or weakened in the name of global regulatory cooperation. Those customer protections are more necessary today than ever because of the increasingly global nature of derivatives markets.

Self-Regulatory System

The continuing success of the CBOT over the years is attributable in large part to our ability and willingness to provide a fair and open marketplace, where market participants of all sizes and types know that the prices of the commodities traded are arrived at in a transparent and competitive process. Market participants around the globe know and rely on our commitment to vigorous, even-handed self-regulation, enhanced by the oversight function of the Commodity Futures Trading Commission under the watchful eye of Congress and this Committee. This

long-standing model of private and government cooperation embedded within the Act remains vibrant.

The CBOT, like other U.S. futures exchanges, carries out a vigorous regulatory program over its members. We regulate ourselves, and discipline our members when necessary, because the Act and Commission regulations require it, because those who use our facility expect it and, most importantly, because it is the right thing to do. The Commission, through its Rule Enforcement Review Program periodically evaluates our regulatory programs and, from time to time makes suggestions for incremental improvement. Without fail, however, these Rule Enforcement Reviews have acknowledged the good job we have done in maintaining a superior self-regulatory system.

This regulatory cooperation has also allowed us to develop other cost-effective means of regulating the behavior of futures professionals and other market participants. Under the supervision of the CFTC, U.S. futures exchanges and the National Futures Association formed the Joint Audit Committee. Through the Joint Audit Committee, U.S. exchanges can fulfill many of their self-regulatory obligations while reducing duplicative audits and the resultant regulatory costs on firms that are members of more than one exchange. This is accomplished by allowing one Designated Self-Regulatory Organization to audit each member on behalf of all.

Some have speculated that the movement on the part of exchanges to for-profit status would lead to conflicts of interest between self regulatory obligations and economic self-interest. Nothing could be further from the truth. Any exchange, any business for that matter, recognizes the importance of being, and being perceived as, honorable and fair. The Chicago Board of Trade is, and will continue to be, dedicated to these principles. The Chicago Board of Trade is presently going through the process of becoming a for-profit organization. I assure the

Committee that this new status, while enabling us to compete more efficiently with other exchanges from around the globe, will not lessen our dedication to fair and forceful self-regulation.

Effective and credible exchange self-regulation requires the participation of persons who are knowledgeable about the sometimes arcane business of futures trading and who are dedicated to the well-being of the exchange and the participants who utilize its facilities. The Board of Directors and crucial committees must also contain a sufficient number of directors who are independent of the exchange, in other words, not materially affiliated with the exchange. The Chicago Board of Trade hopes and expects that regulators and others who are interested in the composition of self-regulatory organizations will keep in mind that independence of directors or committee members should not be subject to rigid standards or definitions that equate independence with a complete lack of knowledge concerning futures trading. For example, a member of an exchange who has no other material ties to the exchange should not automatically be excluded from the definition of "independent."

Conclusion

As the industry continues to evolve, and new challenges arise, regulatory flexibility may become even more important. Just as important, however, will be the preservation of proven elements of customer protection. The marketplace wants and deserves an appropriate level of safety and consistency of regulation.

The Chicago Board of Trade will respond to any questions the Committee or any Member may have and will provide any assistance you may deem necessary.

Thank you for this opportunity to appear before you.